

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:RFP:[REDACTED]:2:POSTF-133870-02
[REDACTED]

date: July 12, 2002

to: [REDACTED], Revenue Agent

from: Associate Area Counsel (LMSB), [REDACTED]

subject: Opinion - Stock Compensation

Taxpayers: [REDACTED]
[REDACTED]
[REDACTED]

This memorandum responds to your office's ongoing request for assistance on this taxpayer. We are coordinating this matter with Mergers & Acquisitions Industry Counsel Lawrence Davidow. This memorandum should not be cited as precedent.

ISSUE

Whether the taxpayer is allowed to take losses generated by certain stock compensation related transactions.

CONCLUSION

The losses generated by the transactions are not allowable as they derive from an impermissible stock compensation tax shelter.

FACTS

[REDACTED] ([REDACTED]), a Delaware corporation, is the common parent of a group of affiliated corporations that file a consolidated return. [REDACTED]'s common stock is publicly traded on various securities markets.

The issue addressed in this memorandum involves transactions relating to [REDACTED]'s employee stock compensation (and related) plans for taxable year [REDACTED]. For this memorandum we take the facts from the [REDACTED] [REDACTED] memorandum discussing the transactions relating to the [REDACTED] stock compensation plans. We understand that at the audit site you

have a considerable number of other documents relating to the plans and transactions. Our opinion, of course, may differ to the extent that the facts of the plans and the transactions differ from the facts set forth in the [REDACTED] memorandum.

Pursuant to various compensation, incentive, and employee stock purchase plans, [REDACTED] gives certain employees and other service providers¹ nonqualified options to buy [REDACTED] stock. The option grants constitute compensation for services.

In [REDACTED], [REDACTED] announced a program to buy back at least [REDACTED] shares of its stock. In [REDACTED] [REDACTED] announced a program to buy back shares of its stock with an aggregate value of up to \$[REDACTED].

The taxpayer contends that credit-rating agencies view negatively a corporation's repurchase of its stock, unless the corporation is committed to reissuing the stock over a period of time not in excess of three years. The reissuance of the stock may take the form of employee compensation payments. The taxpayer says that to satisfy their concerns, credit agencies generally require that the repurchased stock be held in grantor trusts or similar entities with terms that require the short term reissuance of the stock.

[REDACTED] and certain of its subsidiaries formed a partnership called [REDACTED]. The partners executed an Agreement of Partnership on [REDACTED]. The partnership formed [REDACTED] ([REDACTED]) [REDACTED], a Delaware corporation ([REDACTED]).

In [REDACTED], [REDACTED] purchased [REDACTED] stock from [REDACTED] shareholders. On some unspecified date, [REDACTED]'s governing documents were amended to provide that [REDACTED] would transfer to option holders or sell its holding of [REDACTED] stock by [REDACTED].

[REDACTED] and certain of its subsidiaries made capital contributions to the [REDACTED] (partnership). The partnership, in turn, contributed the funds to [REDACTED] in exchange for [REDACTED] stock and as additional capital

¹ These employees and other service providers include employees or other service providers of the subsidiaries. In this memorandum, references to [REDACTED]'s employees includes [REDACTED]'s other service providers and employees and other service providers of [REDACTED]'s subsidiary corporations.

contributions. used the funds to acquire stock on the open market from unrelated third parties.

The partnership, its corporate partners, and entered into an agreement. The agreement and's restated bylaws caused to operate in a trust-like manner. assumed "trustee-like duties with respect to".

notified the trustee when an employee or other service provider gave notice of intent to exercise an option. The trustee then directed to transfer shares from its holdings of stock to the option holder. generally used a broker to make the transfers.

When it transferred shares to an option holder, received no consideration in return. The taxpayer says that recipients of the shares included in income the amount by which the value of the stock received exceeded the amount paid by the recipient upon exercise of the option.

sold to unrelated third parties any stock holdings not transferred to option holders. On , liquidated.

The taxpayer recharacterized's transfer of shares to employees as a transfer by to followed by's compensatory transfer of stock to its employees. Because was owned by , the transaction may also be recharacterized as's transfer of stock to the partnership, which then transferred the stock to its partners (and certain of its subsidiaries), which then transferred the stock to employees of and its subsidiaries. The taxpayer, however, treats as indirectly owning % of , and its explanations leave out the intermediary deemed transactions involving the .

recognizes that, pursuant to I.R.C. § 301, the transactions might be characterized as involving a corporation's (s) distribution of property (stock) to a shareholder (with respect to its stock. However, the taxpayer contends that Treas. Reg. § 1.83-6(d) requires it to treat the transfers instead as's deemed capital contributions to followed by transfers by to's employees.

Treating the transfer as a deemed capital contribution, included nothing in income as a result of the stock it was deemed to have received from (it did not treat the stock

as a taxable dividend). treated its deemed transfer of the stock to its employees as deductible compensation. Upon transferring stock to employees, increased its basis in its remaining stock by the amount of the basis of the transferred stock. Upon selling its remaining holdings of stock to unrelated third parties, claimed a large loss.

This office does not have information regarding any earnings and profits of . served to acquire and transfer stock. It conducted no real profit objective business activities; however, it may have had some sort of passive income from its asset holdings.

ANALYSIS

1. 's deemed transfer of stock to is properly treated as an I.R.C. § 301 distribution.

Generally, I.R.C. § 301 applies when a corporation distributes property to a shareholder with respect its stock. The shareholder includes in income the amount of the distribution constituting a dividend. The amount of the distribution not constituting a dividend is applied against and reduces the shareholder's adjusted basis in the stock. A distribution that is not a dividend and that exceeds the shareholder's adjusted basis in the stock is generally treated as gain from the sale or exchange of property. I.R.C. § 301(c)(1), (2), and (3). A corporation's payment of a shareholder liability is treated as a distribution to the shareholder with respect to the shareholder's stock. See Tennessee Securities Inc. v. Commissioner, 674 F.2d 570, 573 (6th Cir. 1982) citing Old Colony Trust Co. v. Commissioner, 279 U.S. 716 (1929).

I.R.C. § 83 sets forth certain rules with respect to the transfer of property in connection with services. While the § 83 rules generally apply with respect to property an employer transfers to employees or other service providers, Treas. Reg. § 1.83-6(d) sets forth special rules for transfers by shareholders. It says, in part, that if a shareholder transfers property to a corporate employee or other service provider as compensation for

services performed for the corporation, the transaction shall be considered to be a contribution of such property to the capital of such corporation by the shareholder, and immediately thereafter a transfer of such property by the corporation to the employee or independent contractor.

Treas. Reg. § 1.83-6(d)(1).

IRS Notice 2000-60 warns taxpayers that losses generated by certain stock compensation transactions relying on Treas. Reg. § 1.83-6(d) are not allowable. The Service has determined that the subject transactions constitute a corporate tax shelter.

Notice 2000-60 describes a typical stock compensation tax shelter transaction as generally involving three parties: "a domestic corporation (P) that is the common parent of a consolidated group, a domestic subsidiary (S), and a third party (X) that either is unrelated to petitioner or is related but is not an includible corporation within the meaning of § 1504(b)" P and X contribute funds to S in exchange for S stock. X owns preferred stock and P owns less than 80% of the voting power of S (thereby keeping S from constituting a § 1504 includible corporation). S purchases P stock on the open market. S distributes P stock to P's employees as compensation owed by P to the employees.

The [REDACTED] facts vary slightly, but not materially, from the transaction described generally in Notice 2000-60. [REDACTED], a Delaware corporation, is the common parent of a consolidated group. It resembles "P" of the Notice. [REDACTED] is made up of, and is funded by, [REDACTED] and certain of its subsidiary corporations. The partnership transfers cash to [REDACTED] in exchange for [REDACTED] stock. The partnership is like "X" in the Notice, or perhaps more correctly a combination of X and P. In any event, the partnership serves the same purposes that X serves: it keeps [REDACTED] from being includible in the [REDACTED] consolidated group. [REDACTED] is comparable to "S" in the Notice: it is controlled by [REDACTED], it buys [REDACTED] stock on the open market, and it transfers [REDACTED] stock to [REDACTED] employees as compensation for services performed by [REDACTED] employees.

[REDACTED] and [REDACTED] treated their stock transactions the same as "P" and "S" treated the transaction described in Notice 2000-60. The taxpayer treats [REDACTED]'s transfers to [REDACTED]'s employees as a deemed capital contribution by [REDACTED] to [REDACTED] followed by [REDACTED]'s transfer of the stock to its employees as compensation for services performed by the employees for [REDACTED]. [REDACTED] reports no income resulting from its deemed receipt of the stock and it deducts as compensation the amount the employees include in income resulting from [REDACTED]'s deemed stock transfer to the employees. The [REDACTED] stock compensation transactions constitute the type of transactions covered by Notice 2000-60.

To make the tax shelter work, [REDACTED] needs to ignore I.R.C. § 301 and rely instead on the literal language of Treas. Reg. § 1.83-6(d). Treas. Reg. § 1.83-6 sets forth certain rules for an employer deducting amounts when the employer transfers property to service providers in situations that include employees exercising options as part of a stock compensation plan. Treas. Reg. § 1.83-6(d) provides certain rules when a stockholder of the corporate employer, rather than the corporate employer itself, transfers the stock (or other property) to the employees as compensation for services provided to the corporation. The regulation states that "the transaction shall be considered to be a contribution of such property to the capital of such corporation by the shareholder" [REDACTED] concludes that the use of the word "shall" in the regulation requires it to apply Treas. Reg. § 1.83-6(d), rather than I.R.C. § 301, to the [REDACTED] transactions.

However, as discussed in Notice 2000-60, Treas. Reg. § 1.83-6(d)'s characterization of shareholder transfers constituting deemed capital contributions applies only when the shareholder acts in its capacity as a shareholder. [REDACTED] controlled [REDACTED], while [REDACTED] happened to own some [REDACTED] stock. A controlled corporation ([REDACTED]) should not be allowed to avoid distribution treatment merely by owning shares of stock of the controlling corporation ([REDACTED]). Permitting such an avoidance of distribution treatment improperly contravenes the purpose of § 301. Characterizing [REDACTED]'s transfers as capital contributions is inconsistent with the substance of the transactions. [REDACTED], under [REDACTED]'s control, had no plausible investment motive for making the stock transfers to [REDACTED]'s employees. In substance [REDACTED], and not some shareholder concerned about its investment in [REDACTED], transferred the stock to the employees.

The facts and circumstances of a situation determine whether a payment constitutes a capital contribution. If a transaction fits within two Code sections, then the facts, circumstances, and the purpose of the statutory provisions may be used to determine the proper tax consequences. The proper application of a regulation requires reading the language of the regulation in context. See Crosby Valve & Gage Co. v. Commissioner, 380 F.2d 146 (1st Cir. 1967) (where transfers were literally described in two Code sections, the court looked at the purposes Congress sought to achieve); Textron, Inc. v. Commissioner, 115 T.C. 104 (2000) (the court found that, among other things, interpreting a consolidated return regulation i) required reading the language thereof in context, ii) should not lead to an unreasonable result, and iii) should not be incongruous with the purpose of the regulation).

If we include the conduit, the transfers are properly characterized as █████'s distributions to the partnership with respect to the partnership's stock ownership of █████ followed by the partnership's distribution to █████ and subsidiaries with respect to their partnership interests, followed by █████'s (and the subsidiary partners') compensatory transfer of the stock to █████ employees. The distributions to the partnership are treated as dividends to the extent of █████'s earnings and profits. To the extent the distributions exceeded █████'s earnings and profits, they reduce the partnership's basis in the █████ stock. This will reduce or eliminate the loss reported by the taxpayer as a result of █████'s liquidation.

█████ recognizes gain at the time of transfer to the extent that the value of the █████ stock exceeded █████'s adjusted basis therein. The deemed transfer to █████ is treated as if the stock were sold to █████ at fair market value. I.R.C. § 311(b)(1).

As proper characterization of the transaction does not involve any deemed capital contribution by █████ to █████, █████ may not shift basis from the transferred █████ stock to the remaining stock held by █████. █████ does not have a loss with respect to its sale of █████ stock to unrelated third parties prior to its liquidation.

2. The substance of the transactions may also be characterized as █████'s redemption of stock followed by █████'s transferring treasury stock to its employees, thereby ignoring or collapsing the nonsubstantive intermediate steps.

The Supreme Court has held that the tax effect of a transaction depends upon its substance, and that permitting "the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress." Commissioner v. Court Holding Co., 324 U.S. 331, 334 (1945). The Court will not "exalt artifice above reality." Gregory v. Helvering, 293 U.S. 465, 470 (1935). If the form of a transaction is unreal or a sham, the Service "may sustain or disregard the effect of the fiction as best serves the purposes of the tax statute." Higgins v. Smith, 308 U.S. 473, 477 (1940).

Under certain circumstances, the IRS may deal with purportedly separate steps as integrated. Determining the true nature of a set of transactions and their proper tax consequences may require linking together the interrelated transactions,

rather than treating each in isolation. See Commissioner v. Clark 489 U.S. 726, 738 (1989); Kornfeld v. Commissioner, 137 F.3d 1231 (10th Cir. 1998) aff'g T.C. Memo. 1996-472.

Here, the substance of the transactions consisted of [REDACTED] acquiring stock from shareholders followed by compensatory stock transfers to employees. [REDACTED] created a number of formal intermediary steps. The taxpayer created the partnership and [REDACTED]. [REDACTED] and certain subsidiaries were partners of the partnership. The partnership owned [REDACTED]. [REDACTED], rather than [REDACTED], bought stock on the open market and transferred it to [REDACTED] employees. Creating the additional complexity of using a newly formed partnership and a newly formed corporation for purposes of buying and transferring the stock served as a means for creating tax benefits.

The Service may also assert that [REDACTED] acted merely as the agent for [REDACTED]. The actions of the agent are properly attributable to its principal. [REDACTED] was [REDACTED] % controlled by [REDACTED]. [REDACTED]'s purpose was to acquire [REDACTED] stock and distribute it to [REDACTED] employees (and sell any left over stock); [REDACTED] had no profit making objectives. [REDACTED]'s governing documents limited [REDACTED] to this activity directed at satisfying [REDACTED]'s stock compensation obligations. The taxpayer recognizes that the stock transferred by [REDACTED] to [REDACTED] employees is properly treated as a transfer to the employees from [REDACTED]. [REDACTED] acted as [REDACTED]'s agent and not as a principal. See Commissioner v. Bollinger, 485 U.S. 340 (1988).

[REDACTED] apparently contends that [REDACTED] was established to satisfy the concerns of credit rating agencies. However, we know of nothing to support the claim that credit rating agencies would have been concerned about [REDACTED] redeeming stock pursuant to a plan to transfer approximately the same amount of stock to employees. [REDACTED] does not explain how the use of the partnership and [REDACTED] enhanced its credit worthiness.

As an alternative basis for an adjustment, you may apply substance over form and agency principles in finding that the transactions consisted of [REDACTED] redeeming stock followed by a compensatory transfer of treasury stock to its employees.

3. The [REDACTED] liquidation loss is not allowable because it is artificial and lacks economic substance.

[REDACTED] claimed a large loss from the liquidation of [REDACTED]. This loss results from [REDACTED] having had increased the basis in its remaining holdings of [REDACTED] stock by the amount of the [REDACTED]'s

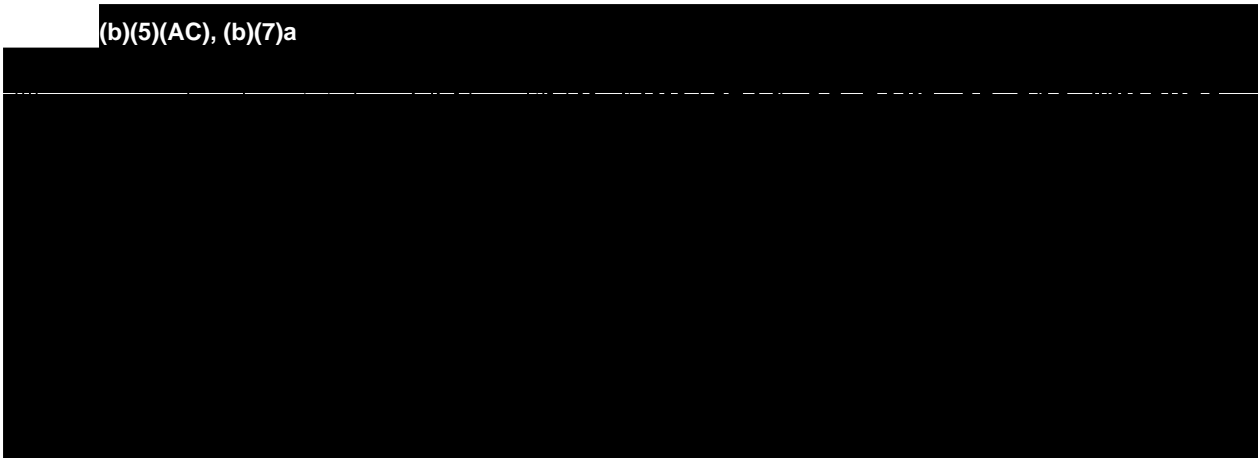
adjusted basis in the stock it transferred to [REDACTED] employees.

[REDACTED] deducted as compensation the amount of the compensatory stock transfers that its employees included in income as a result of the [REDACTED] transfers. At the same time that the stock was transferred to the employees (and [REDACTED] took a compensation deduction), [REDACTED] increased the basis in its remaining holdings of [REDACTED] stock by the amount of the adjusted basis of the stock transferred to the employees, which amount served to generate the purported loss upon liquidation. [REDACTED] seeks to obtain a double benefit for the same expense.

The [REDACTED] loss is artificial. It does not reflect economic reality. The loss serves to provide [REDACTED] with a deduction with respect to an amount already expensed and deducted as compensation. The loss is not allowable. See I.R.C. § 165(a); Treas. Reg. § 1.165-1(b); ACM Partnership v. Commissioner, 157 F.3d 231, 252 (3rd Cir. 1998), cert. denied, 526 U.S. 1017 (1999).

4. Factual development

(b)(5)(AC), (b)(7)a



We are requesting the national office's 10 day post review of this opinion. It is possible that the national office may supplement, revise, or change the advice contained herein. Please do not act on this advice until the national office completes its 10 day review.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse affect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

If you have any questions on this matter, please call
[REDACTED] of this office at [REDACTED].

[REDACTED]
Associate Area Counsel (LMSB),
[REDACTED]

By: _____
[REDACTED]
Attorney

cc (by e-mail only):

Lawrence Davidow, Mergers & Acquisitions Industry Counsel, Manhattan
[REDACTED], Associate Area Counsel (IP), [REDACTED]
Barbara Franklin, Senior Legal Counsel (LMSB), National Office
[REDACTED], Associate Area Counsel (LMSB), [REDACTED]
[REDACTED], Acting Associate Area Counsel (LMSB), [REDACTED]
[REDACTED], Area Counsel (LMSB), [REDACTED]
[REDACTED], Associate Area Counsel (SL), [REDACTED]